Executive Compensation

Additional Executive Compensation
Issues Emerging from the COVID-19 Crisis

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In our previous column,¹ we noted that with the country’s citizens and economy struggling to survive and recover from the COVID-19 crisis’s fearsome fallout, the issue of executive compensation is understandably not the primary focus of the public or media. The pandemic has proven to be as persistent as it is perilous and the country has still not been able to emerge from its threat and effects. As a result, the topic of executive compensation requires further review as organizations seek to attract and retain individuals who can successfully navigate them through this crisis.

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historically challenging course they now face. Our previous column mainly concentrated on the crisis’s effect on salary and nonqualified deferred compensation plans (NDCPs). In this column we first summarize some of the additional IRS guidance on NDCPs released since then. The remainder of the column focuses on some other areas of executive compensation that should be examined in light of the current conditions.

GUIDANCE CLEARS WAY FOR CERTAIN CANCELLATIONS OF NDCP DEFERRALS

Generally, Section 409A of the Internal Revenue Code of 1986, as amended (the Code), requires participant elections to defer compensation under NDCPs to be made prior to the year of reference and to be irrevocable for such year.2 There is an exception to this rule, however, that allows participants to cancel deferral elections midyear due to an unforeseeable emergency or a hardship distribution from a 401(k) plan.3 The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provides organizations that sponsor 401(k) and other tax-qualified retirement plans options to afford their employees who are affected by COVID-19 greater access to their savings by temporarily allowing “coronavirus-related distributions”.4 The CARES Act defines a coronavirus-related distribution as any distribution from an eligible retirement plan to a qualified individual made on or after January 1, 2020, and before December 31, 2020, and limits the amount of aggregate distributions from all eligible retirement plans that can be treated as coronavirus-related distributions to no more than $100,000.5 The IRS issued guidance in June 2020 stating that if NDCP participants receive a distribution from an eligible retirement plan that constitutes “a coronavirus-related distribution,” such distribution will be considered a hardship distribution for purpose of 409A, thereby permitting an NDCP to provide its participants with the option to cancel (but not postpone or delay) their compensation deferral elections for the balance of 2020. Alternatively, the NDCPs of such participants may automatically cancel these deferral elections.6

Therefore, NDCP sponsors may amend their plans to provide that a participant’s receipt of a coronavirus-related distribution either:

- Automatically suspends the participant’s deferral elections for 2020 under the NDCP; or

- Permits the participant to cancel their deferral elections for 2020 under the NDCP.

However, a plan that either automatically revokes or permits participants to elect to revoke an NDCP deferral election cannot allow
such participants to make a new deferral election under the plan until the next plan year. Furthermore, any such deferral election cannot be reduced (i.e., the only available options are either to keep it in place as is or revoke it entirely).\textsuperscript{7}

Accordingly, NDCP sponsors interested in either of these two options must take the necessary steps to prepare and adopt an amendment to their NDCP and should provide NDCP participants with timely notice of the automatic or discretionary suspension provision that is adopted.

**EXISTING PERFORMANCE AWARDS CRITERIA MAY NO LONGER MEASURE UP**

Similar to the situation that arose with the financial crisis of 2008, many organizations must now review their annual and long-term incentive plans to ascertain whether they will remain effective during this period of substantial financial volatility. The amounts payable under these plans, or the vesting of awards under these plans, are often based all or in part on achievement of performance goals by the company, a particular division, and/or the individual plan participant. The COVID-19 crisis has presented challenges for many companies to achieve certain executive-specific, division-specific, and company-wide performance goals as well as corresponding targets that were established at the beginning of 2020 (or an earlier year for long-term plans) due to extreme stock price fluctuations, reductions in revenue, cash flow drains, and/or personnel issues related to the COVID-19 crisis. Although some industries and economic sectors have recovered from the initial impact of COVID-19, a number of other industries and economic sectors have not and will not be able to meet their executive-specific, division-specific, and companywide performance goals. Consequently, organizations sponsoring such arrangements must now determine if they need to:

- Modify any pre-established performance goals;
- Amend such plans, programs, and practices (including the associated awards); or
- Terminate such plans and replace with substitute plans.

For many years, public company annual and long-term incentive plans were generally designed to comply with the performance-based compensation exception to Code Section 162(m) (as described below), which generally does not permit changes to performance goals after they were set in the beginning of the performance period. The Tax
Cuts and Jobs Act of 2017 (TCJA) eliminated the performance-based compensation exception, subject to a grandfather provision discussed below. Accordingly, most annual and long-term cash incentive plans are no longer required to be designed to comply with the performance-based exception to Code Section 162(m). Thus, it may now be possible for employers to modify performance goals under many of such plans. Some current plans may allow the company the discretion to unilaterally adjust performance goals or accelerate performance vesting, particularly if such is to the benefit of the participant. Other plans may allow the grant of discretionary bonuses if performance targets are not met. Plans that do not specifically allow employers to unilaterally change performance goals may allow for the unilateral amendment of such plans, provided the amendment is to the benefit of the employees. In addition, many plans will allow the plan to be unilaterally terminated, after which the company may put a new plan in place. In the case where the plan does not allow unilateral action by the company, the company may want to seek consent from the plan participants, which should not be difficult to achieve if the proposed action will result in increasing the value of bonuses or awards under the plan.

Accordingly, if a company has a performance-based annual or long-term incentive plan where it is clear that performance goals will not be met due to the COVID-19 crisis, such company may consider reviewing the plan documents carefully to determine whether and how it could modify such plan or the performance goals under such plan. The company should also review communications to employees about any such plans to ensure its actions do not contradict its communications.

Finally, if a company has a plan that does not allow for adjustment of performance goals or unilateral amendment, in the event that such plan will not have value going forward, such company could put a second plan in place that will have value going forward, or communicate that it will make discretionary bonuses outside of the existing plan. A communication to participants that they will be eligible for discretionary bonuses in the event that performance goals in the current plan are not met may provide comfort to employees.

Despite the passage of TCJA, the performance-based compensation exemption of Code Section 162(m) still applies to certain plans. The performance-based compensation exemption provides that certain performance-based compensation is exempt from the deduction limits of 162(m), which generally does not allow compensation above $1 million to be deductible for “covered employees” in any taxable year. “Covered employees” are generally the CEO, CFO, and the next three highest paid executives of the company. This exemption still
can apply to certain grandfathered arrangements. These grandfathered arrangements include amounts payable pursuant to a written binding contract that was in effect on November 2, 2017.\textsuperscript{11} Grandfathered arrangements may also include certain arrangements or plans adopted prior to a company going public, if such company went public before December 20, 2019.\textsuperscript{12} These grandfathered plans generally cannot be modified without losing the “grandfather” treatment and, hence, the performance goals under such plans cannot be modified under the terms of such plans, at least with respect to the covered employees, without losing the tax deduction available to performance-based compensation exemption for covered employees under Code Section 162(m).\textsuperscript{13} In addition, some plans designed to comply with the performance-based compensation exception by their terms do not allow changing performance goals at all or do not permit changes to the performance provisions without shareholder approval. Companies with these grandfathered plans will need to review the plan documents to determine what, if any, flexibility they have in changing performance goals, or amending the plan, with respect to employees who are not covered employees.

Public companies that change performance goals for executives will need to disclose such changes to the public and may face scrutiny from institutional shareholders. Institutional Shareholder Services (ISS) has stated the following on this issue:

Many boards are likely to announce plans to materially change the performance metrics, goals, or targets used in their short-term compensation plans in response to the drop in the markets and the possible recession that many economists now predict in the wake of the pandemic. While decisions by directors to make such adjustments to 2020 compensation programs generally will be analyzed and addressed by shareholders at next year’s [annual general meetings] (i.e., in 2021), boards are encouraged to provide contemporaneous disclosure to shareholders of their rationales for making such changes. Such disclosures will provide shareholders with greater insights now and next year into the board’s rationale and circumstances when the changes are made.

Regarding long-term compensation plans, our benchmark voting policies generally are not supportive of changes to midstream or in-flight awards since they cover multi-year periods. Accordingly, we will look at any such in-flight changes made to long-term awards on a case-by-case basis to determine if directors exercised appropriate discretion and provided adequate explanation to shareholders of the rationale for changes.
Going forward, it is also possible that some boards may consider altering the structures of their long-term plans to take the new economic environment into consideration. ISS will assess such structural changes under our existing benchmark policy frameworks.¹⁴

Accordingly, public companies should consider the policies of ISS and other institutional shareholders on these issues and make sure they have an appropriate story to tell shareholders in their next proxy as to why any changes were justified. In the event that the economy quickly recovers, changes in the performance goals may look worse to institutional shareholders if, at the end of the day, the original targets are actually met or if such changes result in awards that are viewed as excessive compensation.

Companies should consider if any amendments to plans would cause issues under 409A. However, as most annual and long-term cash incentive plans are designed to be exempt from 409A and, even if plans are not exempt, changing the performance goals and not the payment dates will usually not create issues under Code Section 409A. In the event that a company desires to cancel a plan that is subject to Code Section 409A and replace it with another plan, the company needs to determine that such will not be deemed a substitution under Code Section 409A that will result in a violation of Code Section 409A.¹⁵ Whether there is such a substitution requires an analysis of the facts and circumstances but a substitution may occur if the date of payment of deferred compensation is changed to an earlier or later date or if the amount of deferred compensation is offset or reduced by another payment.¹⁶

**REVIEWING RETENTION AND SEVERANCE POLICIES**

Companies that have been severely affected by the COVID-19 crisis may have executives and employees concerned about a future bankruptcy filing or the company going out of business, and who, therefore, may begin to seek new employment. Accordingly, companies in such a position should review their compensation plans to determine how much their executives and employees are incentivized to remain with the company and ride out the storm. In the midst of the COVID-19 crisis, numerous companies in this crisis have put new retention plans in place incentivizing employees to remain employed for a year or other specified period in order to receive a bonus. Retention bonuses can be paid in cash or stock. Some companies have put prepaid retention plans in place on the eve of bankruptcy that require the prepaid retention amount paid prior to a bankruptcy filing to
be paid back if the employees leave prior to a specified date. Other companies put key employee retention plans in place following a bankruptcy filing. Companies, however, must consider the potential downside to putting such plans in place. For instance, for public companies, expensive retention plans may raise issues with institutional shareholders. In the bankruptcy context, expensive retention plans may be challenged by the creditors. A prepaid plan put in place shortly before bankruptcy filing may be challenged as a fraudulent conveyance.

Companies heavily affected by this crisis should also review their severance plans and policies. Executives with severance protection will likely be more comfortable remaining through the crisis as he or she has the comfort of a severance period to look for new work if things go badly. Putting in a broad-based severance policy can also give comfort to rank and file employees. Companies that are short on cash, however, may not be able to put a new severance plan in place. In such case, a company may want to consider a policy of vesting equity awards or extending the post-termination exercise period of options for employees who are terminated so that such employees know they will not leave empty handed if they are laid off.

**PAY CUTS MAY PIERCE GOLDEN PARACHUTES RESULTING IN FREEFALL INTO EXCISE TAX**

Compensation cuts have been a highly prevalent response to the COVID-19 pandemic, with many firms asking or mandating executives to reduce their cash compensation or waive their rights to payment or settlement of awards in order to help preserve cash. In the event any such executives may be subject to the “golden parachute” rules under Code Section 280G and Code Section 4999, such salary reduction could increase their excise tax exposure if their employer undergoes a future change in control. Under these rules, if an executive receives more than three times the executive’s “base amount” in conjunction with a change in control, the executive will be subject to a 20-percent excise tax for payments made in connection with a change in control that are above one-times their base amount.\(^{17}\) The “base amount” is generally an executive’s average W-2 compensation of five years prior to the change in control.\(^{18}\) Accordingly, if an executive has a base amount of $500,000, he or she will be subject to the excise tax if the parachute payment received in a change in control equals or exceeds $1.5 million, and the excise tax will be on the amounts that exceed $500,000. Thus, if the parachute payments total $2 million, the executive is over the threshold and will owe a
20-percent tax on the $1.5 million excess parachute payment. Since a significant compensation cut in 2020 would likely reduce the “base amount” for any change in control that occurs in 2021 or later, such cut would thus increase the amounts potentially subject to excise taxes. For example, if due to decreases in compensation one’s “base amount” decreases to $400,000, such an executive would be subject to the 20-percent excise tax if the parachute payment exceeds $1.2 million and would owe tax on any amounts above $400,000. This result is also undesirable from the company’s perspective because another consequence of the payment exceeding the threshold is that the employer will lose the tax deduction to which it normally would be entitled in connection with the executive’s pay. Such a result could be particularly problematic for public companies that are not permitted to take advantage of the golden parachute payment shareholder approval process that is only available for non-publicly traded companies.

COVID-19 CRISIS CREATES DEPRESSED STOCK PRICES

One of the initial common financial symptoms of the COVID-19 crisis has been widespread lowered valuations for both public and private employers. Although there have been strong stock market rebounds since the severe drops from the middle of March for certain economic sectors, other economic sectors have not had a rebound in their stock price and many companies in such sectors are still facing the prospect of a bankruptcy filing if the COVID-19 crisis continues. Given the continuing uncertainty surrounding the COVID-19 crisis, such employers may wish to consider their options in the event that there will be no rebound for their stock price or if there may be future market declines due the continuation of the COVID-19 crisis. Such drops in stock prices can potentially produce significant negative consequences on equity plans and outstanding equity awards.

Standing Pat

If a company believes its reduced stock price is temporary and that the stock will recover when the crisis is over, or if it does not have enough shares in the share pool to grant new awards, the best course for the company may be to stand pat with respect to its outstanding equity awards. Granting new awards or repricing options in a temporary crisis may result in excessive compensation if the stock rebounds when the temporary crisis is over. For public companies,
this will be viewed negatively by institutional shareholders. For private companies, granting new awards or repricing options will create additional dilution that will negatively affect the return of their investors. Taking the position of standing pat will require communication with employees to try to reassure them that the crisis is temporary and that their equity will be worth something after the recovery. Companies that decide to stand pat on equity awards may want to try to make up for such awards having reduced value with other benefits.

**Refresh Grants**

One way to address equity awards that have reduced value due to a depressed stock price would be to grant additional equity awards or awards with a larger number of shares to employees. For example, if the stock price is down 50 percent, the company can make the employee whole by making an additional grant with an equal number of shares. One issue with granting additional awards or awards with a larger number of shares is that it creates additional dilution to other shareholders. In addition, equity plans have a set share pool and, for public companies, shareholder approval will be required to increase the number of shares in the share pool. Such shareholder approval may raise issues with institutional investors, depending upon the dilution that will result from increasing the share pool. In private companies, increases to the share pool may be undesirable for the private equity investors who will not want to see their returns diluted. For companies facing potential bankruptcy, the granting of new equity awards will likely not provide much incentive as such awards are likely to have little value upon exit from a bankruptcy.

**Cash Awards**

Companies that do not have sufficient shares reserved for new equity issuances or where making such new grants would cause excessive dilution of other shareholders, such companies may consider granting cash awards or other cash-based benefits to make up for the reduced value of equity awards. Such cash awards could be a long-term cash incentive plan or equity awards that are payable in cash (or payable in cash or stock at the discretion of the company). A company may consider if it is possible to amend existing equity awards so that they are payable in cash. Unfortunately, in this crisis, many companies are short on cash. Accordingly, if a company is currently short on cash, they may put in a deferred compensation plan.
where cash will only be paid down the road or upon a sale of the company. This may provide less comfort to employees but may be the best the company can do.

For public companies, additional cash awards may be viewed negatively by institutional shareholders unless they are subject to substantive performance goals. As discussed above, these cash awards may be seen as excessive compensation if the stock price and the value of equity awards rebounds.

A company should also seek advice from their accountants with respect to the accounting implications of granting cash awards. For example, an equity award payable in cash will generally be treated as a liability award under Accounting Standards Codification (ASC) Topic 718 and, hence, rather than having the fair value at grant expensed over the vesting period as is the case with most equity awards, the fair value will be adjusted on a quarterly basis and can result in a larger compensation expense. Companies should also take care that cash awards are structured to be exempt from or comply with Code Section 409A.

Underwater Stock Options

One common result of reduced stock prices is that outstanding stock options often become significantly out of the money. A stock option with a $50 exercise price provides employees with little incentive when the stock price is at $10. As discussed above, a company may address this situation by standing pat, granting refresh awards, or granting cash awards. In addition, a company with such underwater options may consider repricing or engaging in an exchange as described below:

Repricing

Companies with underwater options may want to consider a repricing tactic. A “repricing” of options is generally a unilateral action by the company to reduce the exercise price of underwater options. Repricing stock options raises many issues. For public companies, NYSE and NASDAQ rules require that repricings will generally need to be approved by the company’s shareholders unless the plan specifically allows for repricing without shareholder approval. If a plan does allow for repricing without shareholder approval, such repricing will likely raise issues with institutional shareholders. ISS has stated the following with respect to repricing in the COVID-19 crisis:
While stock options are not as widely used as they once were, they are still used broadly by many U.S. companies and in some other markets, and it is possible that some companies may seek to reprice (or replace/exchange/cancel and re-grant) “out-of-the-money” awards. If boards undertake repricing actions without asking shareholders to approve or ratify their actions in a timely fashion, the directors’ actions will remain subject to scrutiny under the U.S. benchmark policy board accountability provisions (and equivalents in other market policies where relevant). If boards seek shareholder approval/ratification of repricing actions at 2020 meetings, we will apply our existing case-by-case policy approach for the relevant market. Under this policy for the U.S. market, for example, ISS will generally recommend opposing any repricing that occurs within one year of a precipitous drop in the company’s stock price. Among other factors, we will also examine whether (1) the design is shareholder value neutral (a value-for-value exchange), (2) surrendered options are not added back to the plan reserve, (3) replacement awards do not vest immediately, and (4) executive officers and directors are excluded. We consider this approach to continue to be appropriate during the circumstances of the COVID-19 pandemic.20

Repricing will also result in an incremental compensation expense under ASC Topic 718 to the extent the repriced options have a higher fair value than the original options. Companies sometimes reduce the number of shares subject to the repriced option in order to avoid such incremental compensation expense. Repricings in situations where employee consent is required may require compliance with the self-tender rules discussed below.

A repricing of options will generally not raise issues under Code Section 409A, as the repriced options will generally be treated as newly granted options as of the date of the repricing, and, if the repriced options have an exercise price equal to the fair market value of the underlying stock on the date of the repricing, they should still be exempt from Code Section 409A.21

Exchange Program

An exchange program typically involves exchanging underwater options for new options, restricted stock, or other types of equity or even cash. Thus, an exchange program is similar to a repricing—although in a repricing the exercise price of the option is generally just reduced, while in an exchange program the option is cancelled in exchange for a new option with a lower exercise price or different type of equity award. Accordingly, exchange programs generally
have the same issues as repricing of options. An exchange program for publicly traded companies will generally require shareholder approval of such a program unless the plan specifically permits repricing or such an exchange. Engaging in an exchange program without shareholder approval will likely raise issues with ISS and other institutional shareholders as discussed above.

Awards granted in an exchange program will result in an incremental compensation expense to the extent the new options or other replacement awards have a higher fair value than the original options. An exchange program will generally require complying with the self-tender rules requiring the filing of a Schedule TO with the Securities and Exchange Commission (SEC). Such rules generally require that participants receive a formal offer document with certain required information, including the terms of the offer and the procedures to be followed. In addition, the offer must be kept open for 20 days and is subject to SEC review.22

A company should also consider if its equity plans allow for recycling of shares underlying cancelled options in an exchange program so that such cancelled shares can be used for future grants.

**Profits Interests**

Profits Interests generally allow management in private companies to participate in the sale proceeds in an exit event if the sale proceeds exceed a certain participation threshold. Such interests are typically granted in the case of a private company that is structured as a limited liability company (LLC) or partnership or in the case where there is a management LLC or partnership that owns interests in an underlying operating company. In the current crisis there may be such LLCs, partnerships, or underlying operating companies whose valuation is greatly depressed such that there may be little prospect of receiving sale proceeds exceeding the participation threshold of the profits interests. In these situations, it is unlikely any amounts will be payable with respect to the profits interests, and they will no longer provide much incentive for management going forward. Accordingly, in such case it may be worth considering granting management additional profits interests or other capital interests that will have value upon an exit event with proceeds lower than the participation threshold of the original profits interests. The other investors in a private company, however, may not want to issue additional interests that might dilute their return.
As an alternative to granting additional equity interests, a company may want to consider putting a cash or phantom equity plan in place that will pay management a fixed amount of cash or a portion of the cash proceeds when the company is eventually sold. These plans are often structured as phantom equity plans that mirror the value of certain units in the LLC or partnership. While profits interests are generally eligible to be taxed at capital gains rates, any cash or phantom plan has the disadvantage of having payments taxed at ordinary income rates. In addition, a cash or phantom equity plan will need to be structured to be exempt from, or to comply with, Code Section 409A. This means that: (1) the plan requires that the participants are still employed at the time of the exit event; (2) that the exit event needs to occur within a certain number of years from the grant date; or (3) that the exit event constitutes a change in control that is compliant with the requirements set forth in Code Section 409A.

ADDITIONAL ISSUES TO CONSIDER DURING THE COVID-19 CRISIS

Existing Restrictive Covenants

Companies that may have to lay-off or terminate executives or other employees in the future if the COVID-19 crisis persists should review the restrictive covenants their executives and other employees are bound by, as such employees are likely to look for jobs with competitors after being laid off. Accordingly, such companies should be aware of its employees’ ability to become employed by a competitor, to solicit employees or customers, or to disclose or use confidential information acquired during the course of such employees’ employment.

If a company’s executives or other critical employees are not currently subject to any restrictive covenants, there may be time to put such covenants in place, provided that the company will have to offer the executive or employee appropriate consideration, generally compensation, as consideration to enter into such covenants. In instances where a company establishes a new retention or severance plan in response to the COVID-19 crisis, such a new plan will create an opportunity to bind executives or other employees to new restrictive covenant provisions. While enforceability of such restrictive covenants is a matter of state law, companies should carefully craft any new covenants to ensure that they protect the legitimate interests of the business and are not overly broad. Given the nature of the COVID-19 crisis, courts, particularly in more
employee-friendly states, may be more reluctant to enforce, or in blue pencil states, to amend, restrictive covenants that are constructed too broadly.

**Succession Planning**

COVID-19 has caused a significant impact on the business and operations of many companies, causing such companies to focus on succession planning, particularly for the C-suite and other critical roles. In uncertain times, companies should have a contingency plan in place to ensure that key positions remain staffed should any individuals in critical roles become ill, quit, be incapacitated, or pass away. Companies may also consider identifying potential future leaders in critical roles or in potential growth areas of the business. Such succession or contingency planning should focus on critical areas of the business, and strategically consider how certain roles may need to evolve as a result of the process and how certain roles at the company should change to focus on potential growth areas of the business.

**Communicating Cuts and Changes**

Changes or reductions in compensation, layoffs, and termination are some of the most difficult issues for companies to communicate with executives and employees. Companies should carefully consider how to approach such communications to not create moral problems for existing employees and, perhaps, unwanted resignations. Companies may want to stress the temporary nature of the current crisis and the steps they have taken or plan to take to make employees whole for reduced compensation.

**CLOSING**

As the COVID-19 pandemic and its fallout persists throughout 2020, the discussion has evolved from surviving a short-term crisis to adapting to a “new normal.” Accordingly, employers will continue to face many challenges as they seek to attract and retain the top talent and leadership vital to not only their future success but also to survival itself. The key will be to implement sound planning and processes that strike the delicate balance between managing costs and providing effective retention and incentive vehicles. There is no “one-size-fits-all” solution, so employers will need to find the approach that is most effective for their unique circumstances while fully understanding the
numerous contractual, accounting, taxation, and disclosure implications that may result from its decisions. Consequently, each employer must be sure to maintain ongoing communication between its compensation committee, board of the directors, key executives, and shareholders and to seek the counsel of its legal and tax experts for this ongoing process of determining and maintaining the right executive compensation strategy for the organization.

NOTES

4. See Sec. 2202 of the CARES Act.
5. Id.
7. See Sec. VI of Notice 2020-50.
16. Id.
18. Treas. Reg. § 1.280G-1 Q/A 34.
22. See 17 CFR § 240.13e-4 for details on tender offer requirements.